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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

1998 Biennial Regulatory Review -
Review of Accounting and Cost
Allocation Requirements

United States Telephone Association
Petition for Rulemaking

CC Docket No. 98-56
RM-9101

ASD File No. 98-64

REPLY COMMENTS
of the
GENERAL SERVICES ADMINISTRATION

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Table of Contents

	<u>Page No.</u>
SUMMARY	i
I. INTRODUCTION	1
II. THE LARGE ILECS PROPOSE SIGNIFICANT REDUCTIONS IN EXISTING ACCOUNTING SAFEGUARDS.	2
III. THE ILECS RETAIN SIGNIFICANT MARKET POWER IN THE LOCAL EXCHANGE AND EXCHANGE ACCESS MARKETS	4
IV. EFFECTIVE ACCOUNTING SAFEGUARDS REMAIN NECESSARY TO PREVENT ILEC ABUSE OF THEIR MARKET POWER.	5
V. FINANCIAL BOOK DEPRECIATION IS NOT APPROPRIATE FOR REGULATORY PURPOSES.	9
VI. CONCLUSION	11

Summary

The NPRM in this proceeding proposes the reduction or elimination of a number of accounting-related filing requirements for all ILECs. The NPRM also raises the revenue threshold for classification of ILECs as Class A carriers from \$112 million to \$7 billion, thus reducing the accounting requirements imposed on "mid-sized" ILECs. The NPRM proposes that Cost Accounting Manual audits of mid-sized ILECs be conducted biennially, instead of annually, and that the standards for these audits be relaxed to some degree.

In their Comments, the Large ILECs go far beyond the NPRM's proposals and suggest the elimination or drastic relaxation of virtually all existing accounting safeguards, including:

- the elimination of Class A accounting rules for all ILECs;
- the elimination of the Commission's Part 64 cost allocation rules; and
- the use of financial book depreciation for regulatory purposes.

The Large ILECs contend that it is unfair to burden them with accounting rules not applicable to CLECs, and that the Commission's price cap rules make stringent accounting safeguards unnecessary.

The Large ILECs are wrong on both counts. First of all, the public interest requires the economic regulation of any public utility whose prices are not constrained by market forces. Since the ILECs retain overwhelming market power in the market for local exchange and exchange access, they must continue to be economically regulated. Since the CLECs have no market power, they should not be subject to economic regulation.

Second, the Commission's accounting responsibilities are mandated by the Communications Act, and apply to all carrier costs - not just those reflecting resources used in the provision of interstate service. The Commission's interstate price cap rules are not relevant to the need for stringent accounting safeguards to protect the consumers of intrastate service.

Of course, stringent accounting safeguards also protect consumers of interstate services. Since the Commission's price cap rules permit low-end adjustments if a carrier's interstate earnings fall below a specified benchmark, ratepayers must be assured that carrier earnings are fairly calculated. In fact, the Commission's monitoring of the price cap plan itself depends upon accurate earnings calculations. The analysis of cost support required under various circumstances also demands accurate accounting.

Finally, the Large ILEC's proposal to use financial book depreciation for regulatory purposes is not only inappropriate for this proceeding, it has also been recently rejected by the Commission.

In summary, the Large ILEC's proposals are without merit and should be rejected.

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**REPLY COMMENTS
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GENERAL SERVICES ADMINISTRATION**

The General Services Administration ("GSA") submits these Reply Comments on behalf of the customer interests of all Federal Executive Agencies ("FEAs") in response to the Commission's Notice of Proposed Rulemaking ("NPRM") released on June 17, 1998. In the NPRM, the Commission seeks comments and replies on the need to repeal or modify its accounting and cost allocation rules. This proceeding is pursuant to the mandate for a biennial review of the Commission's regulations in view of the current state of competition for telecommunications services.

I. INTRODUCTION

Pursuant to Section 201(a)(4) of the Federal Property and Administrative Services Act of 1949, as amended, 40 U.S.C. 481(a)(4), GSA is vested with the responsibility to represent the customer interests of the FEAs before Federal and state regulatory agencies. The FEAs require a wide array of interexchange and local telecommunications services.

From their perspective as end users, the FEAs have consistently supported the Commission's efforts to bring the benefits of competitive markets to consumers of all telecommunications services.

Comments were filed in response to the NPRM by the following parties:

- The United States Telephone Association ("USTA") and five large incumbent local exchange carriers ("Large ILECs").
- The Independent Telephone & Telecommunications Alliance and five smaller ILECs.
- COMSAT Mobile Communications, and
- MCI Telecommunications Corporation ("MCI").

In these Reply Comments, GSA responds to the positions advanced by these parties.

II. THE LARGE ILECS PROPOSE SIGNIFICANT REDUCTIONS IN EXISTING ACCOUNTING SAFEGUARDS

Early this year the Commission staff informally requested industry recommendations for streamlining its accounting and cost allocation rules. In response, USTA provided specific proposals to the staff on February 19, May 1 and June 4.¹ Various individual ILECs also provided the staff with their suggestions.²

After considering these suggestions, the staff prepared the NPRM initiating this proceeding. The NPRM proposes the reduction or elimination of a number of filing

¹ Comments of USTA, p. 3.

² Id., pp. 3-4.

requirements for all ILECs.³ The NPRM also raises the revenue threshold for classification of ILECs as Class A carriers from \$112 million to \$7 billion, thus reducing the accounting requirements imposed on “mid-sized” ILECs.⁴ The NPRM states that this action will continue to provide the Commission with Class A accounting data for nearly 90% of the industry.⁵ The NPRM also proposes that Cost Accounting Manual (“CAM”) audits of mid-sized ILECs be conducted biennially, instead of annually, and that the standards for these audits be relaxed to some degree.⁶

The Large ILECs contend that the Commission’s proposals fall far short of the “fundamental overhaul of these outdated rules that is needed.”⁷ The Large ILECs propose the elimination or drastic relaxation of virtually all existing accounting safeguards, including:

- the elimination of Class A accounting rules for all ILECs;⁸
- the elimination of the Commission’s Part 64 cost allocation rules;⁹ and
- the use of financial book depreciation for regulatory purposes.¹⁰

³ NPRM, para. 13-19.

⁴ Id., para. 3-8.

⁵ Id., para. 4.

⁶ Id., para. 9-12.

⁷ Comments of Bell Atlantic, p. 1.

⁸ Comments of USTA, p. i.

⁹ Id., p. ii.

¹⁰ Id., p. 26.

The Large LECs base their proposals on two main arguments. First, they contend that it is unfair to burden ILECs with accounting rules that are not applicable to competitive local exchange carriers ("CLECs").¹¹ Second, they contend that the Commission's existing accounting safeguards are unnecessary.¹²

As will be demonstrated below, neither of these contentions is valid.

III. THE ILECS RETAIN SIGNIFICANT MARKET POWER IN THE LOCAL EXCHANGE AND EXCHANGE ACCESS MARKETS

USTA states:

Pursuant to the competitive policy required by the Telecommunications Act, it does not make sense for the federal government to impose burdensome and costly regulations on one class of competitor while permitting other competitors complete freedom from regulation.¹³

GSA disagrees. The public interest requires the economic regulation of any public utility whose prices are not constrained by market forces. The issue is whether the ILECs still retain market power in the local exchange and exchange access markets, not whether CLECs exist or not.

GSA has consistently supported the Commission's efforts to bring full and open competition to all telecommunications markets. These efforts have already resulted in effective competition in the customer premises equipment and long distance markets.

¹¹ Id., p. 6.

¹² Id., pp. 6-28.

¹³ Id., p. 6.

GSA also supports the removal of economic regulation as soon as effective competition can be relied upon to prevent market power abuse.

Unfortunately, however, that day has not yet arrived in the market for local exchange and exchange access services. The Commission has reported that the ILECs had a 99 percent share of local service revenues in 1996.¹⁴ While CLECs are beginning to make some progress in penetrating urban business markets, there is but token competition in the residential and non-urban business markets.

The Commission must not be persuaded by the ILECs to put the cart before the horse. First must come effective competition, then deregulation. Were the Commission to deregulate before competition becomes effective, ratepayers would be harmed in the short-run by prices above just and reasonable levels. Even worse, the market power abuses of an unregulated incumbent might prevent competition from ever reaching effective levels.

IV. EFFECTIVE ACCOUNTING SAFEGUARDS REMAIN NECESSARY TO PREVENT ILEC ABUSE OF THEIR MARKET POWER

The Large ILECs second contention is that the Commission's stringent accounting safeguards are no longer necessary. The Large ILECs base this argument primarily upon the Commission's elimination of sharing as an element of its price cap system.¹⁵ This argument cannot stand close scrutiny.

¹⁴ Trends in Telephone Service, February 1998, Table 8.1.

¹⁵ See, e.g., Comments of USTA, p. 9; BellSouth, p. 10; GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE"), pp. 5-6.

In the first place, the Commission's accounting and cost allocation responsibilities are clearly stated in the Communications Act of 1934:

The Commission shall, by rule, prescribe a uniform system of accounts for use by telephone companies. Such uniform system shall require that each common carrier shall maintain a system of accounting methods, procedures, and techniques (including accounts and supporting records and memoranda) which shall ensure a proper allocation of all costs to and among telecommunications services, facilities, and products (and to and among classes of such services, facilities, and products) which are developed, manufactured, or offered by such common carrier.¹⁶

The Commission has met this requirement through the establishment of rules in Part 32 (Uniform System of Accounts), Part 64 (Allocation of Costs) and Part 36 (Jurisdictional Separation of Costs) of Title 47 of the Code of Federal Regulations. It is important to note that these accounting regulations apply to all carrier costs - not just those reflecting resources used in the provision of interstate services. In fact, the majority of carrier costs are assigned to the intrastate jurisdiction and thus regulated by state commissions. The Commission's accounting responsibilities have thus always been largely for the benefit of state regulation, irrespective of how it chooses to regulate interstate access. While some state commissions require subsidiary accounting records of various types for use in state ratemaking, all state commissions depend upon the Commission's maintenance of appropriate accounting, cost allocation and jurisdictional separation rules. Broadly speaking, therefore, the Commission's interstate price cap rules are of minimal significance

¹⁶ Communications Act of 1934, Section 220 (a)(2).

to the question of whether stringent accounting safeguards are necessary.

Indeed, the Commission's Part 64 rules are specifically designed to remove nonregulated costs from total costs before jurisdictional separation to prevent cross-subsidization. As the Commission has recognized, the Telecommunications Act of 1996¹⁷ broadened the Commission's mandate to prohibit the cross-subsidization of any competitive service with services that are not.¹⁸ To give full effect to this change, the Commission codified this prohibition in Part 64 of its rules.¹⁹ The elimination of Part 64 would thus be in direct contravention of the 1996 Act.

This is not to say that stringent accounting safeguards are not still necessary for effective interstate regulation under the Commission's price cap rules. In the first place, the Commission's rules permit low-end adjustment if interstate earnings fall below specified benchmarks. Ameritech dismisses this issue by noting that the low end adjustment has rarely been used in the past.²⁰

Indeed, few price cap carriers have experienced years of low earnings under the interstate price cap plan. To the contrary, the rates of return for almost all price cap carriers have grown extraordinarily high since the plan's inception, as the following table shows:²¹

¹⁷ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) ("1996 Act") amending the Communications Act of 1934 ("Act").

¹⁸ 47 U.S.C. 254 (k).

¹⁹ Implementation of Section 254(k) of the Communications Act of 1934, as Amended, Order, FCC 97-163, released May 8, 1997, para. 9.

²⁰ Comments of Ameritech, p. 11.

²¹ Trends in Telephone Service, July 1998, Table 14.1.

<u>Year</u>	<u>Mean</u>	<u>Maximum</u>
1991	11.78%	17.27%
1992	12.42	17.72
1993	13.12	22.33
1994	13.58	32.60
1995	14.02	47.29
1996	15.15	42.53
1997	15.64	48.86

When compared to the authorized interstate rate of return (11.25%) and the forward-looking ILEC cost of capital (closer to 10% as found by many state commissions in recent Section 251 proceedings), ILEC interstate earnings levels are well above. They indicate both continuing ILEC market power and the failure of the interstate price cap plan to ensure just and reasonable rates. As such, these rates of return must be as out of line to the ILECs as they are to the Commission. In the future it can be hoped that returns will be very high for only those companies who achieve extraordinary productivity improvement. Conversely, it can be expected that more companies will find a need for the low-end adjustment provision of the price cap plan.

The above rates of return also illustrate the importance of accurate and meaningful data for use in monitoring the performance of the price cap plan. In GSA's view, the price cap plan has not adequately protected ratepayers in the past, and the accounting system has identified the extent of this inadequacy. The abandonment of stringent accounting safeguards would not only leave ratepayers vulnerable to market power abuse by the ILECs, but it would deprive them of the tools by which to measure that abuse.

The Commission's price cap plan allows carriers to file exogenous factor adjustments, rates exceeding existing price caps, and new service rates with appropriate cost support. As MCI has noted, Class A accounting provides the Commission with

“essential tools” for investigation of such filings.²² The analysis of detailed cost support often is heavily reliant on access to detailed historical data in order to test for reasonableness. Experience in state Section 251 and universal service proceedings has confirmed that detailed historical data is often key to the development of forward-looking cost projections and their analysis. Such analysis depends upon details related to data available only in the Class A system of accounts.²³

In summary, the stringent accounting safeguards developed by the Commission remain necessary to prevent ILEC abuse of their market power despite the elimination of sharing from the interstate price cap plan.

V. FINANCIAL BOOK DEPRECIATION IS NOT APPROPRIATE FOR REGULATORY PURPOSES

Some Large ILECs have recommended in their comments that they be permitted to use financial book depreciation for regulatory purposes.²⁴ As SBC notes, however, the Commission’s depreciation practices will be subject to a separate proceeding later this year, and this issue need not be addressed in this proceeding.²⁵

Nevertheless, it is worth noting that the Commission has recently addressed this very issue. The depreciation lives used for financial accounting purposes are governed by

²² Comments of MCI, Summary.

²³ For example, costs related to digital as opposed to analog switching, or buried as opposed to aerial cable.

²⁴ See, e.g., Comments of USTA, p. 26.

²⁵ Comments of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell (“SBC”), footnote 54.

the Generally Accepted Accounting Principle ("GAAP") of "conservatism." In the FCC's Prescription Simplification proceeding, GTE noted that the GAAP conservatism principle "prefers the understatement (versus overstatement) of net income and net assets where any potential measurement problems exist."²⁶ Most accountants would agree that the very nature of depreciation makes it difficult to measure. GAAP, independent auditors and the Security and Exchange Commission, therefore, might well prevent the ILECs from understating depreciation, since this would overstate net income and net assets. It is highly unlikely, however, that GAAP, or any financial auditor, would find that an ILEC (or any company, for that matter) had overstated its depreciation, since this would result in a conservative view of net income and net assets.

In its October 1993 Order, the Commission agreed with GTE, stating:

One of the primary purposes of GAAP is to ensure that a company does not present a misleading picture of its financial condition and operating results by, for example, overstating its asset values or overstating its earnings, which would mislead current and potential investors. GAAP is guided by the conservatism principle which holds, for example, that, when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used. Although conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not "reasonable") depreciation expense by a LEC....²⁷

²⁶ Simplification of the Depreciation Prescription Process, CC Docket No. 92-296 ("Prescription Simplification"), Comments of GTE, March 10, 1993, p. 14.

²⁷ Prescription Simplification, Report and Order, FCC 93-452, released October 20, 1993, para. 46. (Emphasis added).

GSA agrees with the Commission that financial book depreciation is not appropriate for regulatory purposes, since it does not offer adequate protection for ratepayers.


VI. CONCLUSION

As a major user of telecommunications services, GSA urges the Commission to reject the proposals of the Large LECs as discussed in these Reply Comments.

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